THE WORLD ECONOMY

On the edge

The risks of a deep global recession are increasing. But it can be avoided so long as policymakers heed some lessons from history

RELATED ARTICLES

Stockmarkets feel the strain

FURTHER READING

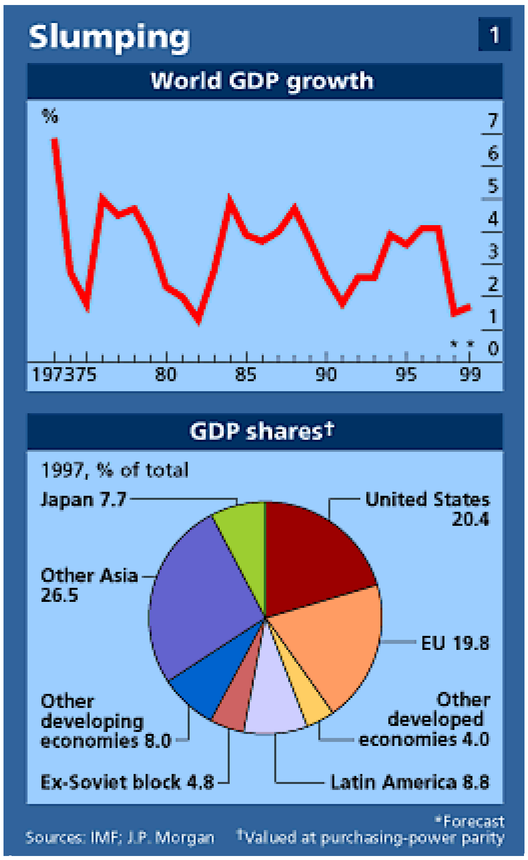
Search archive

"WE ARE today in the middle of the greatest economic catastrophe of the modern world . . . the view is held in Moscow that this is the last, the culminating crisis of capitalism and that the existing order of society will not survive it." Thus spoke John Maynard Keynes in 1931, as world output was tumbling and unemployment everywhere inexorably rising. But plenty of economists might express similar views today. The world economy has become far more dangerously poised even during the past month, let alone over the past year. At the annual meeting of the Federal Reserve Bank of Kansas City in Jackson Hole, Wyoming, over the weekend, some central bankers were privately admitting that these are the worst global economic conditions they have seen in their lifetime.

The economic casualty-list makes depressing reading. Japan and most of the rest of East Asia is in deep recession. GDP is expected to fall by as much as 15% in Indonesia this year, and by 6-7% in South Korea and Thailand. Russia's government has, in effect, defaulted on its debt; its economic predicament worsens by the day. China may yet respond to the sharp slowdown in its economy by devaluing its exchange rate, and the Hong Kong dollar is under severe pressure. Latin America still teeters on the brink.

Even some developed economies, such as Britain's and Canada's, are slowing. And Wall Street has fallen sharply from its peak (see article). Indeed, tumbling share prices have wiped almost $4 trillion off the world's financial wealth over the past two months—the equivalent of Japan's GDP.

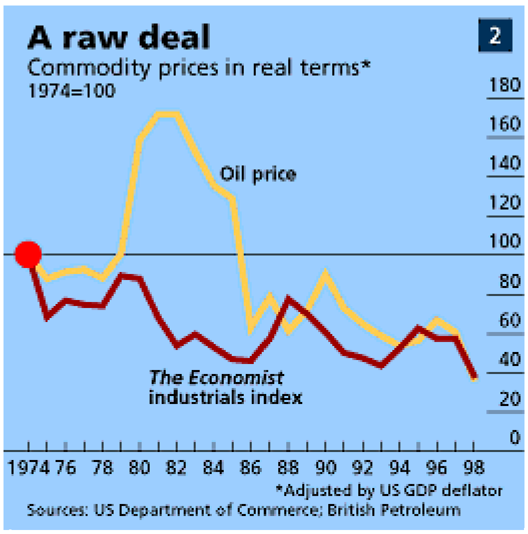
Economies that account for two-fifths of world output, measured at purchasing-power parity, are already in recession or stuttering. World output grew at an average of 4% in 1996 and 1997, but J.P. Morgan, an American bank, now forecasts growth of a mere 1.5% this year and 1.7% next (see chart 1). Admittedly, these are at the gloomier end of the present range of predictions. But if they turn out correct, this would be the same growth over the two years as in 1981-82, the world economy's worst "recession" since the 1930s. And even then, the bank is assuming that America and Europe will continue to grow next year (albeit at sluggish rates, of 1.3% and 2.1% respectively); it also expects a return to modest growth in both Japan and emerging Asia. If instead—as some pessimists expect—Asia fails to recover and America dips into recession, global output could decline next year for the first time in 60 years.



Russia's implosion has triggered a new phase in the emerging-market crisis. Its economy accounts for a mere 2% of world output, so its direct impact on world trade and output is tiny. But the indirect effects—through commodity markets, investors' confidence, the cost of capital—are proving far bigger. Coming on top of other financial troubles, Russia's plight could be the straw that breaks the camel's back.

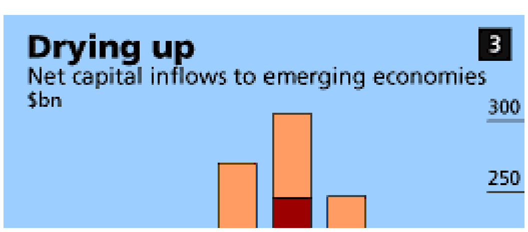
The sickness has spread far and wide: to Eastern Europe, South Africa and Latin America. Venezuela may soon be forced to devalue its currency. Brazil's economy is not in such bad shape as Russia's, but there are some nasty similarities, not least a big budget deficit (7% of GDP). Brazil has suffered a heavy capital outflow in recent weeks. The government may be able to resist a devaluation for a while, but the cost it pays through higher interest rates will be painful. J.P. Morgan now expects Brazil's GDP to contract by 2% next year, reducing growth in Latin America to just 0.8%.

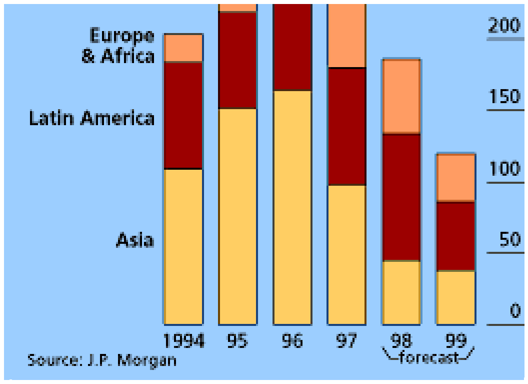
There are two main routes for contagion from Asia and Russia to spread to other economies. The first is commodity prices. East Asian countries are big importers of raw materials, so the slump in the region has savaged the price of oil and other commodites. Fears that Russia might try to boost export revenues by dumping commodities on world markets have exacerbated the decline. *The Economist* all-items commodity-price index has fallen by 30% since mid-1997, to its lowest in real terms for over 25 years. The prices of industrial commodities are now at their lowest in real terms since the 1930s (see chart 2). This has severely hurt commodity producers, not just in Latin America and Africa, but also in Australia and Canada.



A second channel through which emerging-market troubles have spread is investor confidence. Bruised by big losses in Asia and Russia, investors everywhere are fleeing from risky assets into safe havens such as American Treasury bonds. The best measure of this increased perception of risk is that the average yield on emerging-market government bonds has risen to 15 percentage points above the yield on American Treasuries, compared with a mere three points last autumn. Higher costs of borrowing dampen growth throughout the emerging world; they also inflate government debt-servicing costs in countries such as Brazil.

Emerging economies with large current-account deficits, such as Brazil and Poland, may have a particularly tough time as external finance dries up. They may therefore have to curb domestic demand. J.P. Morgan forecasts that total net capital flows to emerging markets will slump to $119 billion in 1999, down from an expected $186 billion this year and $247 billion in 1997 (see chart 3).





Against this litany of woes, however, it is worth noting one small glimmer of hope. In East Asia, export volumes are starting to pick up. Countries such as South Korea and Thailand may this year run current-account surpluses of more than 10% of GDP. As a result, exchange rates have stabilised and interest rates have dropped—South Korea's, for instance, have fallen to 10% from 25% in December. The latest figures show that the East Asian economies experienced big declines in output in the second quarter. But if these trends continue, their economies may stop shrinking by the end of this year.

The bubble bursts

Perhaps the scariest fallout from the latest turmoil in Russia has been the fall in Wall Street and other developed markets. Despite a midweek rally, the Dow Jones Industrial Average is still down by 17% from its peak, wiping out all of this year's gains. Many Wall Street analysts complain that the stockmarket has overreacted to the troubles in Russia, which will have little impact on America's economy and corporate profits. But this misses the point: American share prices had previously risen to extraordinarily high levels by all historical valuation measures—and Russia was simply the reason that investors, already nervous, had needed to start selling.

More dominoes may fall in the emerging world, but the fate of the global economy stands on the shoulders of the American and West European economies, which account for about two-fifths of world output. Both have been enjoying growth of around 3% this year. But for how long can their economies remain immune to the present financial turmoil?

More than two-fifths of America's exports go to developing countries, so it will suffer some fall in demand thanks to their slump. But the biggest risk to the American economy is not a slowdown in exports, but a further big fall in its stockmarket. Wall Street's rise in recent years has proved a powerful engine of growth for America's economy. It has come to be taken for granted—which is dangerous.

Thanks to the bull market, the measured wealth of American households has doubled over the past three years. This has made consumers feel richer, and as a result they have saved less and consumed more. In the second quarter of this year America's personal savings rate fell to a historic low of 0.6%, with consumer spending jumping at an annual rate of 6%. Rising share prices also made it cheaper for firms to raise equity finance, so fuelling a surge in investment. The risk now is that this could all go into reverse, as plunging share prices dent consumer and business confidence.

If the Dow Jones stays close to its current level of nearly 8,000, then the impact on consumer spending may be small, as that still leaves the market 25% higher than in December 1996. But by such measures as price/earnings ratios or the yield gap, Wall Street is still significantly overvalued—the more so since profit growth this year seems to have flattened out.

What if the market plunged? A traditional rule of thumb used by economists is that a $1 gain in wealth eventually raises consumer spending by 3-4 cents. But almost twice as many households now own shares as in the mid-1980s; so the wealth effect is likely now to be larger. Moreover, the wealth effect may be asymmetric: a fall in share prices could reduce economic activity by more than a rise in prices boosts it, because of the greater adverse impact on confidence. On this basis, a 40% drop in share prices could trim consumer spending by 4-5% over two years.

Already there have been loud calls for America to cut interest rates to prevent a global slump. Indeed, forward markets are discounting a cut in short-term interest rates. But a decision by the Federal Reserve to make a quarter-point cut, say, would do little to help Russia, Brazil or Thailand. And anything bigger could risk sparking American inflation.

American interest rates are already lower than they otherwise might be. Had there been no world financial turmoil the Fed would surely have raised rates by now to cool the excessive pace of growth. Many officials at the Fed had been fretting about the growth of a financial bubble in America, and the risk that it might have exploded into future inflation. But if the bubble has now burst, interest rates no longer need to rise to prick it.

Even so, it would be a mistake for the Fed to cut interest rates just yet. For that, it needs clearer evidence of a slowdown in demand, or the prospect that a further plunge in the stockmarket might threaten to choke future spending. There is little sign of either. America's GDP growth slowed to an annual rate of 1.6% in the second quarter of this year, but that was largely due to the strike at GM, a big run-down in inventories and a fall in exports. Domestic demand continued to expand at an annual rate of almost 7%. America's labour market remains tight and money-supply growth has been worryingly rapid.

Fed officials say that, if global economic turmoil looks likely to endanger America's economy, they are ready to cut interest rates. But for the moment the Fed is more likely to keep rates on hold. It has not forgotten the mistake it made in 1987 when, despite rapid money-supply growth, it cut interest rates in an overzealous response to the crash on Wall Street. It was forced to increase rates sharply a year later when inflation began to rise.

On the other side of the Atlantic, there are already fears that Britain may have a mild recession next year. On current trends, however, the continental European countries that will in January join the planned single currency promise to be among the world's fastest-growing in 1999. European households hold less of their wealth in shares, so a stockmarket crash will have little effect on spending. For instance, in France and Germany, household shareholdings are equivalent to less than 20% of their annual disposable income, compared with 100% in America and 65% in Britain.

Indeed, the real fear is that the new European Central Bank, anxious to establish its credentials as guardian of the world's second currency, the euro, will be inclined to be too tough. Peripheral economies such as Ireland's and Spain's have been showing signs of incipient inflation. And the ECB is eager to inherit the fearsome reputation of the German Bundesbank. Should the euro economies falter, there must be a risk that the ECB will be too slow to respond by easing monetary policy.

In any case, if America itself trips up badly it would probably drag Europe down with it. That makes it more worrying that continental European banks are more heavily exposed to both Asia and Russia than are their American counterparts. Whereas American banks seem to have learnt something from their painful mistakes of the early 1980s, the Europeans have taken more risks in order to increase their share of the market. In short, Europe, for all its apparent health, cannot escape unscathed from the world's current turmoil.

The lessons of history

The odds are, however, that total world output will fall next year only if America itself goes into recession. This cannot be ruled out. But so long as policymakers in America and Europe keep their heads—if need be, cutting interest rates and allowing budget deficits to widen—it is unlikely to turn into anything like a 1930s-style depression, when America's GDP fell by 30% over three years. There are many similarities between now and the late 1920s, such as falling commodity prices and an overvalued stockmarket. But as Russell Jones, an economist at Lehman Brothers, points out, there are also some big differences.

First, until the early 1930s countries were on the gold standard—under which their currencies were tied to gold. This restricted their ability to ease monetary policy as economies went into recession after the Wall Street crash of 1929.

Second, governments compounded their tight-money mistake with tight fiscal policies, even in the depth of the depression. Rather than allowing taxes to fall automatically as incomes declined, the Americans raised taxes in 1932 to balance the budget. Not only do governments have a better understanding of macroeconomics today, but now that public spending takes a much bigger share of GDP, their ability to stabilise demand is greater.

The third difference between today and the 1930s is that there were no global organisations such as the G7 or the IMF to oversee the world economy. The IMF was set up in 1944 at the instigation of the Americans to head off any future global economic collapse. Its mission was to foster global economic co-operation and provide temporary financial assistance to countries with balance-of-payments problems.

The IMF is currently under fire from economists and politicians for its handling of the crises in Asia and Russia. They argue that its remedies—tight macroeconomic policies and far-reaching corporate and financial restructuring—have made things worse not better. The most extreme critics think the Fund should be abolished. Meanwhile America's Congress is blocking an urgent increase in its funds.

The IMF's solutions may indeed have been wanting. In hindsight its policies in Asia were too contractionary (and are now being eased), and its requirements for structural reform may have demanded too much in an environment of panic. But the way to resolve these mistakes is to improve the IMF; it is not, as the critics advocate, to withhold much-needed funds.

If the emerging-market crisis deepens and the IMF runs out of money; if Japan continues to delay its plans to rescue its sick banking system; if Wall Street crashes, but the Fed refuses to cut interest rates; if the European Central Bank pushes up interest rates purely to establish its anti-inflationary credentials; if all of the above, then things would indeed look bad for the world economy. But one hopes that not all policymakers could be that incompetent.

One huge policy error in the 1930s was a retreat towards protectionism. In June 1930, Herbert Hoover signed the Smoot-Hawley tariff, which swiftly prompted other countries to retaliate. Today, the protectionists have so far remained quiet. But they will surely become more vocal if America tips into recession—or if its current-account deficit, as is likely, continues to balloon ever upwards.

Capitalism in retreat?

A related and more worrying backlash against free markets is the increasing interest on the part of politicians and economists in market intervention or capital controls as a solution to the crisis. In a radical departure from its free-market tradition, Hong Kong’s government has been intervening heavily to prop up share prices. It says that its aim is to punish speculators that have been selling shares short and betting against the currency in the hope that higher interest rates will push down share prices. On September 1st Malaysia imposed strict controls on capital movements. And respected American economists are also now arguing the virtues of capital controls.

Paul Krugman, an economist at MIT, has argued, in a recent article in *Fortune*, that Asian economies should introduce capital controls. This, he suggests, would break the link between domestic interest rates and exchange rates and so allow governments to cut interest rates to get their economies growing again.

Desperate situations may indeed call for desperate remedies, but this seems nonetheless an odd time to be advocating strong controls on capital. After all, as it were, the horse has already bolted. Introducing severe controls now could well accelerate rather than slow the flight from emerging markets, by making investors even less willing to invest new money. Such controls, if they are not too leaky, inevitably create economic distortions, as well as deterring the long-term foreign direct investment that is essential for growth in developing countries.

Most serious of all, governments that hide behind strict capital controls have less incentive to pursue other essential economic reforms. Market discipline has forced both South Korea and Thailand to implement significant reforms—certainly much more than Malaysia. And they have been rewarded: both have already cut their interest rates sharply this year without weakening their currencies.

Indeed the biggest risk now to the world economy may lie not so much in a deep depression, which could be averted. It is that there may be a wholesale retreat from free markets. Any such retreat would damage longer-term growth prospects, which in many emerging economies have been steadily improving, for decades to come.